Department of Justice

THOMAS J. MILLER
ATTORNEY GENERAL

ADDRESS REPLY TO:
HOOVER BUILDING
DES MOINES, IOWA 50319
TELEPHONE: 515-281-5164
FACSIMILE: 515-281-4902

August 14, 2007

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Home Equity Lending Market Request for Comment
Docket No. OP-1288

Introduction

I commend the Board for conducting hearings and considering regulations to strengthen consumer protections under the Home Ownership and Equity Protection Act (HOEPA). Predatory and abusive mortgage lending is an issue of great importance and one that the States have been at the forefront. In recent years, we have acted together with state banking regulators to attack abusive lending on a national level. Through our efforts, we obtained a $484 million settlement with Household Finance and a $325 million settlement with Ameriquest Mortgage Company. These settlements also resulted in major reforms of the practices of these national subprime lenders and set standards that have been adopted by other lenders. Through these and other enforcement efforts, as well as our handling of consumer complaints, the States have developed significant expertise on the widespread fraud and abuse that has occurred in the subprime mortgage market.

The irresponsible, reckless, and illegal behavior of subprime brokers and lenders has led to a growing national foreclosure crisis. There are estimates that up to 2.2 million subprime homeowners may ultimately be foreclosed upon.[1] Countless other borrowers are struggling to

[1] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeoners* (Center for Responsible Lending, December 2006, at 3).

meet oppressive payment terms and have had significant equity stripped from their homes. One must ask how many hardworking Americans will lose their family home, have their finances ruined, or otherwise sacrifice in order to try to meet an exploding mortgage payment.

Homeowners, however, have not been the only parties adversely affected by the market excesses of the last several years. Over fifty mortgage lenders have gone out of business already this year, with more to come, and the failure of several high profile hedge funds has highlighted the current uncertainty in the investor ranks. All of this underscores the basic proposition that unfair and deceptive practices lead to bad loans and that consumer protection and safety and soundness are linked. The widespread deceptive practices in the subprime industry have proven to be a disaster for homeowners, lenders, and investors.

The question for the Board is what lessons will be learned and what protections will be put in place so that when the inevitable next mortgage cycle begins, these abuses will not be repeated.[2] I urge you to enact comprehensive regulations that will protect both homeowners and responsible market participants from unfair and deceptive practices that have been all too common in recent years.

I. The Board Should Issue Strong Regulations to Prevent Abusive Lending

The subprime mortgage market is a dynamic market and the abuses that have occurred within this market have changed over time. While HOEPA's high-cost structure has been successful in addressing some of the initial abuses, it has been wholly ineffective in addressing the types of abuses that led to the Household and Ameriquest settlements, nor does it cover the inability to pay and lax documentation standards that are prevalent today. New regulations are needed to address these evolving practices and market changes.

In addition, the Board is in a unique position to impact the entire mortgage market. As you are aware, some mortgage market participants are regulated by the federal regulatory agencies while other market participants are regulated by the States. Many market participants cite this problem of an allegedly "uneven playing field" as a reason not to pass laws or regulations, while the States cite to the fact that their consumer protection authority has been eroded by aggressive federal preemption. The Federal Reserve is the only regulatory body that can issue regulations that will require all mortgage market participants to comply with uniform standards, thus eliminating this issue and allowing the predatory lending problem to be decided on its substantive merits, rather than on a competitiveness concern.

---

[2] Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007. For example, while 42% of 2006 subprime Mortgage Backed Securities (MBS) were stated income loans, thus far in 2007a very similar 40.5% of subprime MBS are stated loans. Inside B&C Lending, July 27, 2007, at 2. Similarly, while 72.6% of 2006 subprime MBS were ARMs, that number only dropped to 66.4% in the first half of 2007. *Id.*

I share the Board's concern in striking the correct balance by addressing predatory lending in a way that preserves the incentives for ethical and responsible lenders to provide credit to subprime borrowers. It is my belief that strong regulations will help drive the unethical actors from the marketplace and thus even out the playing field. Over the last several years, the subprime market has created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share, in effect punishing them for refusing to engage in fraud or irresponsible underwriting. In the past, if a lender chose not to engage in some of the well known fraudulent practices, such as stated income fraud, they were in effect engaging in unilateral disarmament. The market incentives rewarded irresponsible lending and made it more difficult for responsible lenders to compete. Strong regulations will create an even playing field in which ethical actors are no longer punished.

II. The Board's Regulations Should Cover All Subprime Loans, and Should Not be Limited to Just High Cost Loans

HOEPA's high cost loan structure has been useful, but it applies to a limited category of loans. Some in the lending community have responded to HOEPA by including automatic price exceptions so that if the HOEPA threshold is crossed, the loan is repriced to just below the trigger. Thus, very few HOEPA loans are being made and the consumer protections that come with those loans are inapplicable.

It is my strong belief that to be effective any regulations by the Board should cover all subprime loans, not just the high cost loans currently covered by HOEPA. After all, the problems the States uncovered in the Household and Ameriquest cases did not involve high cost loans, but regular subprime loans. Although there may be some disagreement over how to define what exactly is a "subprime loan," there are federal standards available for HMDA data reporting purposes and other sources. The Board has the requisite resources to articulate a definition that includes what is generally understood by the lending industry to be a subprime loan.

III. Improved Disclosures are Not the Answer to Abusive Mortgage Practices

It is beyond dispute that current mortgage disclosure documents are outdated and ineffective. As things currently stand, it is very difficult for subprime borrowers to comparison shop among lenders. Current disclosures do not provide information in a way that is readily understandable by the average consumer and the information is provided too late in the process to impact consumer choice.[3] Indeed, most subprime borrowers do not see their final loan terms until they are at the closing table.

While any efforts to improve disclosures are laudable, such efforts must be in addition to and not in lieu of substantive regulations. Enhanced disclosures are unlikely to be effective in

---

[3] *See* Ren S. Essene & William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options For All Americans* (Joint Center for Housing Studies, Harvard University, April 25, 2007).

reducing abuses. No matter how good the disclosure, it will always be subject to misrepresentations, omissions, and downright lying by a loan originator who has every incentive to close the loan. Subprime originators have shown a propensity to engage in deception and misrepresentations which undermine even the best disclosures.

Consumers already face a blizzard of paper at closing and the addition of more disclosures on yet another piece of paper could simply add to the problem, rather than solve it. Worse yet, signed disclosures can often create a safe harbor for fraudulent activity. The ability of a lender to produce a signed disclosure, which was likely seen for the first time at the closing table, is often a powerful defense to any later claims of misconduct. Thus, some disclosures actually give unscrupulous lenders a perverse incentive to engage in oral misrepresentations.

Improved disclosures may help on the margins, but they do not address the core structural problems facing the mortgage industry. You cannot disclose your way out of the problem of predatory lending.

IV. All Subprime Loans Should be Required to be Underwritten According to an Ability to Repay Standard

The use of hybrid ARMs with a low teaser rate and a high margin has unquestionably led to significant payment shock and is a leading cause of the current subprime foreclosure crisis. According to the Mortgage Bankers Association National Delinquency Survey, in the 1st Quarter of 2007 Iowa was 4th in the country in subprime foreclosures at 9.20%. This is despite the fact that the unemployment rate in Iowa was at or near a six-year low of 3.2% during this time period.[4] Thus, there is no local economic condition in Iowa that can account for this level of foreclosures and delinquencies. A much more likely explanation is the significant misconduct that has occurred in recent years. It has been estimated that 7 out of 10 of the early payment defaults that sent the subprime lending system into chaos earlier this year "have been riddled with fraud."[5]

The combination of a 2/28 ARM which is adjusting upward with any other predatory practice often leads to foreclosure. In Iowa, we have unfortunately found that we have a very serious problem with inflated appraisals. The combination of an inflated appraisal with an upward adjusting 2/28 is a deadly combination. Borrowers find themselves unable to afford their new, much larger payment, yet they are unable to refinance or even sell their home because of the inflated appraisal. Absent intervention, this situation leaves little choice but for the borrower to default and ultimately be foreclosed upon. This is but one example of the situations borrowers can find themselves in when they are placed in loans that they cannot afford.

---

[4] Bonnie Harris, *Iowa jobless rate eases to 3.2%*, The Des Moines Register, April 20, 2007, at D1.

[5] Editorial - *Just How Bad Will It Get?*, National Mortgage News, March 5, 2007 at 4 (quoting Robert Norrell, Senior Vice President, Litton Loan Services).

Some in the industry attempt to justify these loans by pointing to the relatively few and rare circumstances where they might be appropriate. The problem is that ARMs are the staple of the subprime market and are frequently used in many inappropriate circumstances. In 2006, 72.6% of all subprime MBS involved adjustable rate loans.[6] Very few subprime borrowers expect a significant decrease in their monthly obligations or conversely a significant increase in income in the next 24 months, certainly not 70%. Given that subprime borrowers already are a higher credit risk, it is curious that rather than choosing to use stable and responsible products the industry has instead chosen to use products that enhance, rather than reduce, the risk of default. Simply put, the industry put short-term growth and volume ahead of long-term sustainability and millions of Americans are now paying the price.

Some lenders argue that hybrid ARMs are "credit repair" products that allow borrowers to improve their credit and then refinance into a prime loan. These argument is belied by the fact that most borrowers who are put in a hybrid ARM also qualify for a fixed rate loan. The basis points difference between a fixed rate loan and the starting rate for a hybrid ARM (which is a floor the rate will never go below) is surprisingly low. In fact, in some instances a fully documented fixed rate loan has a <u>lower interest rate</u> than the starting rate for the hybrid ARM. Thus, assuming for arguments sake that subprime loans are legitimately characterized as credit repair products, one must ask, why not repair that credit with a responsible and possibly cheaper fixed rate loan. Why is it necessary to put continued possession of the home at risk through the use of an exploding hybrid ARM?

Even worse is the fact that many subprime borrowers likely qualified for prime loans. Freddie Mac estimates that 15 to 35% of all subprime loans it bought in 2005 could have qualified for a prime rate, while Fannie Mae amazingly estimates that up to 50% of the borrowers in subprime loans it bought that same year had credit profiles that could have qualified them for prime rates.[7] This is not a zero sum game, where subprime borrowers are either provided with a 2/28 ARM or nothing. The fact that so many subprime borrowers who were put into inappropriate hybrid ARMs also qualify for fixed rate and even prime loans proves that requiring underwriting at the fully indexed rate will not dry up the legitimate subprime market.

Securitization has played a central role in lenders placing borrowers in unaffordable loans because it has separated the origination of a loan from its consequences. When it comes time to foreclose on a loan, the originator is often long removed from the picture and does not feel the true effects. Thus, originators have engaged in predatory practices that a portfolio lender would never engage in, such as inflating an appraisal or inventing borrower income, because they can sell the loan to the secondary market. Unless there is an early payment default, which were rare until earlier this year, the originator is generally off the hook for any loss incurred on the loan. Conversely, the investor is generally not held liable for the acts of the originator. Thus, when a

---

[6] Inside B&C Lending, January 12, 2007, at 2.

[7] Les Christie, *Wow, I could've had a prime mortgage*, CNNMoney.com, May 30, 2007.

loan goes bad, borrowers often find themselves in a catch-22 between the originator and the servicer/investor who now holds the loan.

In short, the secondary market dramatically changed the incentives for originators. Thus, many subprime originators are no longer concerned with the terms of the loan or whether the borrower will ultimately be able to afford the loan. Instead, their incentive is to close the loan as quickly as possible, no matter what, in order to be paid their origination fees and then sell the loan to the secondary market. The problem is even worse for thinly capitalized mortgage brokers who never even fund the loan themselves. Brokers, who originated 63.3% of subprime volume in 2006, simply do not have enough of a stake in the outcome of the loan.[8]

The end result is that mortgages have been transformed into a commodity. Some large, national subprime lenders, many of which have since gone out of business, were essentially sales organizations who just happened to sell debt consolidation refinancings. The core competency of these organizations was marketing and sales, not responsible lending.[9] The depth and breadth of the problems currently facing the subprime market demonstrate that this is a structural problem that is much more than a few bad apples.

While I am very supportive of the Board's recognition of the need for lenders to underwrite loans to assure repayment capacity, this is nothing more than a return to market fundamentals. One would not think it necessary for regulators to have to tell lenders not to make loans that cannot be repaid.

The current subprime mortgage market was built on the belief that double digit gains in home appreciation would continue forever. Thus, originators made loans with the expectation that borrowers who were about to experience payment shock from their hybrid ARM would be forced to come back a mere 24 months later for another round of expensive origination and closing costs, including in many instances paying a prepayment penalty, which all served to further strip homeowner equity. In this way, the subprime lenders and originators created a loop that required borrowers to continually come back to them. It was never intended that borrowers be able to actually afford their loans. It cannot be stressed enough that this is how these loans were structured. Borrowers repeatedly refinanced not to receive a better rate, as in the prime market, but in order to avoid payment shock and ultimately foreclosure. So long as home appreciation continued to rise, this was the perfect product from a lender's point of view. As we all know, however, housing appreciation did not continue forever and the house of cards finally came down. One major mortgage industry publication recently reported that "a stunning 85% of

---

[8] Inside B&C Lending, March 9, 2007, at 4.

[9] Consider, for example, the comments of Bill Templeton, former president of The Money Store, who stated that, "Our core competency was marketing, we just happened to do mortgage loans" and that to be successful subprime lenders should "not be as greedy." *Small Subprime Lender Expects Big Gains this Year*, Inside B&C Lending, February 23, 2007, at 9.

borrowers are 90 days past due on a 2-28 hybrid adjustable-fixed 'within six months of adjustment.'"[10] These borrowers are trapped in loans with escalating payments they cannot afford but without the equity to do another refinancing.

Requiring lenders to stop underwriting loans based on the temporary and artificially low teaser rate will help consumers by encouraging sustainable homeownership. Lax underwriting has made it very easy for people to get into a home, but very hard to stay there. Consumers are not served by being placed in loans that they cannot afford. A loan should be underwritten based on whether the borrower has the income to afford the likely payments. Whether or not someone can afford their mortgage payment should not depend on market appreciation. Whether or not a borrower can sell their home may well depend on appreciation, but not whether they can make the monthly payment. In short, borrowers should not be forced to engage in an endless loop of serial refinancings in order to avoid default and foreclosure because of how their loan was structured.

Therefore, I urge the Board to issue a regulation that underwriting a subprime loan at anything less than the fully indexed rate, assuming a fully amortizing repayment schedule, is an unfair, deceptive, or abusive practice that is not in the interest of the borrower. Any such analysis should not be limited to just principal and interest, but also should include taxes and insurance, as well as any subordinate mortgage liens.

V. Prepayment Penalties Should Be Banned for Subprime Loans

The States' investigations have revealed that prepayment penalties are often the subject of deception and misrepresentation. Many consumers report that they are orally promised that their loan does not contain a prepayment penalty, only to find out at closing, when they are financially committed to the loan, that they do in fact have a prepayment penalty. We have also found that prepayment penalties are often the subject of other misrepresentations, such as promising a borrower that if they refinance with the same lender the prepayment penalty will be waived, when that promise cannot be kept because the loan has been sold to the secondary market.

Subprime loans are often touted as being a bridge to the prime market. The theory is that subprime borrowers improve their credit through timely payment of a higher interest rate loan, and thus are able to refinance into a prime loan. Prepayment penalties, however, stand as a serious obstacle to the subprime borrower attempting to move up the credit ladder. The net effect for a homeowner who faces a long term prepayment penalty is to either see thousands of dollars of their hard earned equity reduced by paying the penalty (a typical penalty is six months' interest) or, if they cannot "afford" the cost of the prepayment penalty, to be forced to continue paying a higher interest rate than they would qualify for with a refinancing.

---

[10]Editorial - *Fraud and Default*, National Mortgage News, March 12, 2007, at 4 (quoting the comments of Stephen Staid, Senior Vice President, Default Administration at Litton Loan Servicing).

Importantly, prepayment penalties do not provide any benefit to consumers that outweigh their negative effects. Industry often claims that those borrowers who choose to have a prepayment penalty are rewarded with a lower interest rate. Empirical research, however, has shown that prepayment penalties do not always result in a lower interest rate for borrowers. A Center for Responsible Lending study showed that in refinance loans, prepayment penalties produced no statistically significant difference in the interest rate paid. In other words, borrowers with prepayment penalties paid similar interest rates to similarly situated borrowers who did not have prepayment penalties.[11] For purchase money loans, borrowers who had subprime loans with prepayment penalties actually paid a higher interest rate than similarly situated borrowers with subprime loans without prepayment penalties.[12]

While the industry often portrays prepayment penalties as a matter of consumer choice, I think the reality is quite different. For most subprime loans, the presence of a prepayment penalty is the default position and most consumers are never presented with a true choice. In fact, our investigations have shown that loan originators often have significant financial incentives to include prepayment penalties in the loan. The fact that only 2% of prime mortgages contain prepayment penalties, as opposed to up to 80% of subprime mortgages,[13] belies any serious notion that consumer choice is driving the extremely high prevalence of prepayment penalties in subprime loans. Thus, I believe that most prepayment penalties are in subprime loans because of lender steering, rather than true consumer choice.

Given the misconduct often associated with prepayment penalties, their absence from the prime market, and the fact that they do not result in a lower interest rate as claimed, the best course is to ban prepayment penalties in subprime loans. In fact, Iowa has banned prepayment penalties in all residential loans since 1978 (See Iowa Code §535.9).[14] This has helped Iowa consumers avoid many of the deceptions discussed above and notably, the prepayment penalty ban has not led to a reduction in access to credit in Iowa.

Because prepayment penalties are a fertile source of deception and misrepresentation, because they make it more difficult for borrowers to refinance into a lower priced loan, and because empirical research has shown that borrowers with prepayment penalties do not always receive a lower interest rate, I urge the Board to issue a regulation banning prepayment penalties

---

[11] Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages* (Center for Responsible Lending, January 2005).

[12] *Id.*

[13] Ernst, *supra* note 11, at 1.

[14] Starting in 1996, Iowa's prepayment penalty ban was preempted as to alternative mortgages, such as ARMs, by the Office of Thrift Supervision (OTS) under AMTPA. The OTS removed the preemption on July 1, 2003, thus restoring the Iowa law.

in subprime loans as an unfair, deceptive, or abusive lending practice that is not in the interest of the borrower.

VI. The Board Should Require Escrow Accounts for Taxes and Insurance

Similar to prepayment penalties, some lenders have used the absence of an escrow for taxes and insurance as an opportunity for deception. When looking at this issue it is important to remember that the primary subprime product is not a purchase money loan for a first time homebuyer, but rather a debt consolidation refinancing.[15] Most subprime lenders' target customer is a current homeowner with substantial unsecured consumer debt, normally credit card debt, who also has equity in his or her home. Subprime lenders sell these loans by convincing financially troubled homeowners that the answer to their problems is to consolidate their unsecured consumer debt into a home mortgage with a lower monthly payment, thereby producing a monthly cash flow savings. Unfortunately, some lenders have engaged in the practice of leaving out taxes and insurance when quoting the new lower monthly payment to the consumer, thereby making it look like there is a larger monthly savings than in fact exists.

Similarly, some originators have deceptively used the absence of an escrow to convince borrowers to refinance with them instead of with their competitors. Obviously a monthly payment that only includes principal and interest will look much better than a monthly payment that also includes taxes and insurance. The absence of any affirmative requirement for escrow accounts on subprime loans has rewarded those lenders who do not escrow, creating a race to the bottom.

More importantly, requiring escrows is a necessary step to ensuring loan affordability. If consumers are not taking taxes and insurance into account when deciding whether or not they can afford a loan, and originators are not taking it into account when deciding whether to extend credit, neither are making an informed decision. The lack of escrow accounts has undoubtedly contributed to the current foreclosure crisis. Thus, I am strongly in favor of requiring escrows for taxes and insurance for all subprime loans. Escrows have long been a staple of the prime market and there is no persuasive reason why subprime and prime loans should be treated differently on this subject.

In addition, lenders have a very strong interest in making sure that homeowners insurance is paid. Thus, it has always been curious why subprime lenders have not required or at least strongly encouraged escrow. In fact, one complaint we frequently hear regarding the servicing of subprime loans is consumers claiming they have paid their homeowners insurance,

---

[15] In 2006, 49.4% of subprime MBS involved cash out refinancing, and in 2005 it was 53.5% (Inside B&C Lending, January 12, 2007, at 2). Importantly, according to the Mortgage Bankers Association only a mere 12% of total subprime loans were purchase loans by a first-time homebuyer in the first half of 2006 and only 15% in the second half of 2006. (*Subprime Lending to First-Time Homebuyers Up in '06*, Inside B&C Lending, July 13, 2007, at 7).

yet the servicer has force placed more expensive insurance onto the loan, in effect creating a back-end escrow. These disputes would end with a required escrow.

Escrow requirements would be a great benefit to consumers. It would give them a true monthly payment and a true gauge of whether or not they can afford the loan. It would also help them budget and avoid the multitude of problems that arise if they get behind on their real estate taxes. It should not affect the types and terms of credit offered, other than to eliminate abusive loans which are made only by ignoring taxes and insurance. In order to curtail deceptive practices in payment quotations and to protect against the potential for default, I urge the Board to issue a regulation stating the originating a subprime loan without an escrow is an unfair, deceptive, or abusive lending practice that is not in the interest of the borrower.

VII. Stated Income or Low Doc Loans Should be Restricted for the Vast Majority of Subprime Loans

Industry participants often refer to stated income loans as "liar loans" and for good reason. Our investigations have found that stated income loans are frequently used to fraudulently qualify borrowers for loans they cannot afford. Because subprime lenders seek out homeowners with high consumer debt, originators face the problem of finding borrowers with adequate income to make the payments on the refinanced loan, and yet stay within an acceptable debt-to-income ratio. In other words, can the originators find borrowers who actually have the income to pay for their substantial consumer debt after it is rolled into the home mortgage.

Because of the substantial pressures and economic incentives to make as many loans as possible, many originators have engaged in a pattern of inventing non-existent occupations or income sources, or simply inflating income totals to support loan applications. A review of 100 stated income loans by one lender found that a shocking 90% of the applications overstated income by 5% or more and almost 60% overstated income by more than 50%.[16] Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.[17]

---

[16] Mortgage Asset Research Institute, *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, April 2006, at 12.

[17] For example, consider the comments made by a former fraud detection specialist:

> "'[F]raud for commission' in which originators will 'do anything' to earn a fee is just as prevalent as fraud for profit.
>
> "'It's pervasive throughout the entire industry' ... 'It's growing because the accountability is not there. Risk management (for fraud) is the Rodney Dangerfield of the mortgage business.'"

Lew Sichelman, *Fraud to Hit $4 Billion Per Year?*, National Mortgage News, March 12, 2007, at 29.

I do not dispute that for a very small, very defined subset of the population, stated income or no doc loans might make sense. The problem is that what was clearly intended to be a niche prime product has been applied to the market generally. In 2006, 42% of subprime MBS were stated or no doc loans.[18] It cannot be seriously argued that 42% of subprime borrowers are self-employed or otherwise cannot easily document their income. Whatever legitimate purposes may exist for stated income loans, they do not come close to justifying the current level of use. Stated income loans have evolved into an escape valve for fraud, giving originators a method by which to invent income that does not exist in order to close loans. It is also my belief that many borrowers are steered into stated income loans because they are easier and faster to process for the lenders, plus they carry a higher interest rate.

Verifying income is critical to conducting a true analysis of a borrower's ability to pay, particularly in connection with loans to borrowers who have demonstrated financial difficulties. A loan that is underwritten based on income that the consumer does not truly have is by definition unaffordable and designed to fail.

Accordingly, stated income loans should generally be prohibited for subprime loans, with a narrowly tailored exception for borrowers who can show mitigating factors that make verification less necessary or unusually difficult. Stated income loans should clearly be barred for wage earners (any borrower who receives a W-2) and for borrowers whose income is solely derived from public benefits. Even for the self-employed, lenders should be required to check the stated income against IRS documents, a requirement which only protects lenders and investors from fraud. If a stated income loan is used, the mitigating factors that led to that decision should be required to be documented.

Finally, if stated income is based on self-employment or a home-based business, the lender should be required to receive and review evidence confirming the existence of the self-employment or home business before using that income to underwrite any portion of the loan. This minimal step, while not foolproof, will help eliminate the common practice of inventing fictitious home based businesses. Again, it must be stressed that in our experience these types of fabrications are often the invention of the mortgage originator, not the borrower.[19]

I believe that the vast majority of borrowers with stated income loans can easily document their income and that most borrowers are not aware that they have a choice between a full documentation or stated loan, much less that they are being charged a higher interest rate for the stated income loan. A restriction on stated income loans would only strengthen the market by helping to eliminate the fraudulent loans. Thus, I urge the Board to essentially codify the position taken by the Federal Agencies in the Statement on Subprime Mortgage Lending. This

---

[18] Inside B&C Lending, January 12, 2007, at 2.

[19] *See* The Register's Editorial, *Beef Up Protections on Mortgage Lending*, The Des Moines Register, February 17, 2007, at 12A (setting forth a common example of stated income fraud).

position would benefit consumers because they will get a lower rate by not doing a stated loan, while still preserving the stated option for those who truly need it.

VIII. The Board Should Prohibit Future Promises to Refinance

One allegation that repeatedly surfaces in our complaints is the tactic of appeasing borrowers who discover a bait and switch at the closing table by promising a future refinancing. For example, many borrowers report that they asked for and were expecting a fixed rate loan, only to see at closing for the first time an ARM. Likewise, borrowers report higher interest rates than they were promised or the presence of a prepayment penalty. Because borrowers are often financially committed to a loan by the time they reach closing (especially when they have not paid their creditors pursuant to the instructions of the lender when doing a debt consolidation refinancing) very few refuse to close the loan or exercise their rescission rights. Instead they are often appeased by a promise from the originator that the terms are in effect temporary, and not to worry about it because the borrower can come back a few years later and they will do a refinancing. Of course, many times when the borrower returns, this promise is not upheld. Even absent a bait and switch, it is my belief that many hybrid ARMs are sold by promising a borrower a future refinancing before the payment shock sets in.

A promise to do a later refinancing is key to many types of consumer lending fraud. It in effect tells the consumer, these terms do not matter, when in fact they matter very much. I urge the Board to adopt a rule barring originators and lenders from representing to borrowers that they will be able to refinance their loan at a later date on more favorable terms unless they provide the borrower a written statement that the lender is contractually bound to refinance the loan and which specifies the date and the more favorable loan terms.

Conclusion

These comments are not intended to be a comprehensive list of all problems in the subprime mortgage market nor all of the possible solutions to those problems. Instead, they are intended to address some of the core problems, which will go a long way towards remedying some of the fraud that has been perpetrated over the last several years. These modest changes will help promote sustainable homeownership, without interjecting uncertainty into the mortgage market. Pursuant to its statutory mandate, the Board should issue these regulations to prohibit such unfair, deceptive, and abusive practices.

Sincerely,

Tom Miller

THOMAS J. MILLER
Attorney General of Iowa